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December 23, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Bay State Gas Company, D.T.E. 02-73

Dear Secretary Cottrell:

Bay State Gas Company ("Bay State" or the "Company") has filed a petition ("Petition") seeking the Department's authorization to incur long-term debt in the amount of up to \$50,000,000. The Company also seeks an exemption from advertising and competitive bid requirements in connection with this proposed debt in order to obtain financing from an affiliated company, NiSource Finance Corp. ("NiSource Finance"). The Attorney General submits this letter as his Initial Brief.

I. INTRODUCTION

Following its merger with NiSource, Inc. ("NiSource"), the parent and holding company, Bay State's bond rating and overall company health has deteriorated significantly. The pre-merger promises of benefits to ratepayers have yet to materialize. The Company is now proposing an affiliate transaction with NiSource Finance to obtain financing in the amount of up to \$50 million. The Company also seeks an exemption from the statutory requirements of advertisement and competitive bidding requirements (G.L. c. 164, § 15), which are designed to safeguard customers from unfair dealing and abuse. The proposed affiliate transaction is fraught with problems and the potential for abuse.

The Company's current proposal fails to safeguard customer interests. The Department, therefore, should either reject the Company's request for an exemption of the competitive bid requirements or cure the deficiencies in the current proposal. To cure the deficiencies, the Department should require the Company to borrow the \$50 million from NiSource Finance Corp upon the same terms as NiSource receives in the competitive market place for the funds from

which the \$50 million Bay State financing is ultimately derived.

II. STANDARD OF REVIEW

Pursuant to G.L. c. 164, § 15, the Department has found that when the proposed debt is not placed directly into the market on a competitive bid basis, the terms of the securities issued in the competitive market place, from which the funds are ultimately derived, should be used to determine the terms of the debt which the utility issues. *Southern Union Company*, D.T.E. 01-80, pp. 17-18.

III. ARGUMENT

A. The Company's Proposal Contains Deficiencies And A Potential For Abuse.

The Bay State proposes to issue debt in a process that is neither the result of competitive bidding as required under Section 15 nor the result of an arms length transaction. The proposal allows NiSource total discretion to set all of the terms of the promissory note including the yield and maturity of the bond. The promissory note is the product of negotiations between affiliates and its terms reflect what is in the best interest of NiSource.

The Legislature has determined that an electric or gas company offering long-term bonds or notes in excess of \$1 million in face amount should do so through a competitive process. G.L. c. 164, § 15. The Department has discretion to grant an exemption from this requirement if it is in the public interest. The Department precedent allows for the grant of an exemption where there has been a measure of competition in the private placement process. *See, e.g., Western Massachusetts Electric Company*, D.P.U. 88-32, at 5 (1988); *Eastern Edison Company*, D.P.U. 88-127, at 11-12 (1988); *Berkshire Gas Company*, D.P.U. 89-12, at 11 (1989). There is no evidence that Bay State's proposed transaction involves some measure of competition. To the contrary, it involves only affiliates of the same holding company.

In the absence of a measure of competition in this financing process, the Department should put safeguards in place to protect both the interests of customers and the Bay State affiliate from self-dealing. NiSource Finance is going to the market with its own \$350 million of long-term financing which the Company expects to effectuate at the end of January. The Department should condition the Bay State financing on the use of the NiSource Finance bond issue as a simple and objective benchmark to determine the terms of the promissory note. This will introduce a measure of competition into this inter-company transaction. This approach is consistent with the Department's decision in *Southern Union Company*, D.T.E. 01-80 (2001). In *Southern Union*, the Company proposed to issue debt to a trust and the trust issued preferred stock to the competitive market. In that case, the Department approved the Company's use of the effective interest rate of the preferred stock as the rate for the debt issued to the trust. *Id.* pp. 17-18. Since NiSource Finance has the incentive to maximize the economic benefits of its \$350 million financing by minimizing its costs, having Bay State simply sign a promissory note for

this transaction with the same terms, yield and maturity of the \$350 million NiSource Finance bond, will mitigate the effects of any potential self-dealing.

B. The Department's Approval of this Financing Should Not Be Construed as a Ruling Relative to the Appropriate Ratemaking Treatment to Be Accorded Any Costs Associated with the Proposed Financing.

Since Bay State's acquisition by NiSource, Inc., Bay State's bond rating has fallen from an A-rated company to a BBB-rated company, thus driving up its cost of capital. Tr., pp. 51, 84-96. The prudence of the Company's capital financing is not an issue in this proceeding. Any Department order in this proceeding should reiterate that the Department's approval of this financing should not be construed as a ruling relative to the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. *Southern Union Company*, D.T.E. 01-80, p. 17. *See Cambridge Electric Light Company v. Department of Public Utilities*, 333 Mass. 536, 538 (1956)(the approval of a financing and the setting of rates are "two kinds of inquiry which the department may be called upon to make [that] do not follow parallel lines and will not necessarily produce nicely dovetailed results.)

The incremental cost of capital resulting from the lowered bond rating is not a cost which should be borne by customers. The Department should require the Company in the next rate case to demonstrate the credit spread for "A" versus "BBB" rated bonds when NiSource Finance goes to market with its \$350 million financing and demonstrate that it is reasonable for customers to pay these higher BBB rates.

In conclusion, the Department should adopt the Attorney General's recommendations discussed above.

Very truly yours,

Wilner Borgella, Jr.
Assistant Attorney General

WB/wb

cc: Caroline O'Brien, Hearing Officer (w/enc.)
Service List (w/enc.)